

The International Spectator 3/2002

## Book reviews and Notes

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# Optimal Choices for Optimal Policies

Stefano Fantacone\*

Political economy in macroeconomics / Allan Drazen. - Princeton : Princeton University Press, c2000. - xiv, 775 p. - ISBN 0-691-09257-5 (pbk)

Allan Drazen has provided us with an invaluable manual in which he reorganises and reinterprets some of the most important results of the last twenty years of economic research.

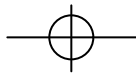
As the author points out, the new political economy is a discipline that is increasingly gaining ground among specialists in the field as well as with those popularising economic issues. Actually, this does not come as a surprise to European readers, traditionally used to reflecting and discussing the effects of political choices on economic trends. Many are also aware that the first theoretical contributions to the science of economics – from Stuart Mill to Adam Smith and David Ricardo – were

dedicated to the principles of political economy.

The point however is that the significance of this field of study has changed over time. Today, what was formerly known as “political economy” is now more commonly identified with the term “economics”, taken to be the study of the factors that determine the individual equilibrium of consumers and enterprises on the market. What then is the correct definition of political economy and why should it be considered new?

It is not easy to define the discipline. Generally, it can be said that political economy deals with the ways in which political decisions affect economic results. But this definition is insufficient and does not account for the ways in which research in that analytical field has to deal with some of the major problems raised by scholars since the mid-seventies –

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problems that seemed to undermine the very foundations of public intervention in the economy, showing how the expected effects of political economy intervention can be annulled by the undesired changes that such measures cause in the economic agents' behaviour.

This leads, in fact, to Robert E. Lucas' famous critique that there is no point in measuring the effects of political economy interventions with econometric models that can only estimate the statistical relations of the past but are unable to take account of changes in expectations for the future.

The primary objective of the new political economy is then to bring analysis of the decision-making processes of policymakers inside the rigorous analytical framework developed by recent economic theory. This actually constitutes a micro-refoundation of policymakers' economic decisions – undoubtedly, a step forward in theoretical elaboration and in the identification of behaviours able to lead policymakers to achieving the results desired.

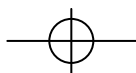
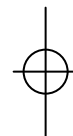
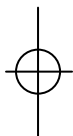
Nevertheless, this step, which is enough to explain the adjective "new", is not enough to clarify the real meaning of political economy. Other disciplines also deal with the optimisation of policymakers' choices, in particular the school of public choice. The distinction Drazen makes with respect to this consolidated line of analysis is illuminating. While the public choice school stops at the

study of optimal choices on the part of the policymaker, the object of new political economy analysis is the effect that the adoption of optimal decision-making mechanisms has on the economy. This definition says a lot of things.

First, it is assumed that if the policymaker has an optimal choice, s/he will take it. This is the positive side of the new political economy, which tries to identify the political constraints that keep policymakers from adopting optimal choices – a fact frequently observed in reality.

Second, the new political economy tries to explain how to remove those political constraints. Hence the normative side of the discipline, which deals not only with how to overcome the political constraints within existing institutions, but aims, much more ambitiously, at indicating the institutions that are most suitable for achieving that objective. Rather than the individual instruments of intervention dear to the traditional approach to economic policy, institutions play a priority role for the new political economy: in order to achieve the objectives, it is the institutions able to coordinate the behaviour of all agents involved that count.

The key concepts stressed throughout the book are "reputation", "commitment", "budgetary rules", "political institutions" and "regime". Exactly how important these analytical tools are can be understood by looking at the recent European experience, char-



acterised by institutions, agreements and kinds of coordination (EMS, Treaty of Maastricht, Pact for Stability and Growth, Open Method of Coordination) specifically devoted to the achievement of common economic objectives (keeping inflation low, lowering the public debt, relaunching prospects for growth).

Drazen's book helps us realise how the progress made in economic theory and the ever increasing analytical rigour inherent in it can be associated with a conclusion of policy effectiveness. Public intervention is still justified by the presence of conflicts of interest among private, rational agents, calling for institutional mechanisms able to find solutions other than those that would arise spontaneously through market forces. From this point of view, Drazen's book is important because it lists the many elements that, albeit within the rigorous framework of the new classic macroeconomics continue to point to the need for public intervention.

The book deals with numerous subjects, making it a real handbook of the field. After surveying the main models used in political economy and illustrating the decision-making mechanisms implicit in the various forms of government (direct democracy, representative democracy, etc.), the book delves into the heart of the matter. First, the concepts of commitment,

credibility and reputation that had such an important influence on theoretical work in the eighties are analysed. Then, the ways in which the presence of heterogeneous agents with conflicts of interest affect the decision-making processes of the public operator are explained. Finally, a number of examples are given of how the analytical tools of political economy help to interpret – and solve – concrete policy problems. Thus the book considers such issues as growth and accumulation, exchange rate arrangements, international policy cooperation, and international capital flows. The last chapters address two specific and very topical matters concerning the problems of transition countries and the factors that explain the size of government.

In conclusion, this book is extremely valuable in that it has undertaken the task of systematically reordering some of the most important results achieved by economic analysis in the last twenty years, translating them into policy options for those in charge of political economy. Indispensable thus and able to enhance the analytical possibilities of anyone involved in economic research, but above all a fundamental reference for the concrete application of political economy.